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## MEMORANDUM

### An Assessment of Avenues to Extend Nicaragua's TPL September 1, 2011

Please find below an assessment of means by which there could be an extension of the Tariff Preference Limit (TPL) of the Dominican Republic-Central America-United States Free Trade Agreement (CAFTA), as well as an assessment of the feasibility of each option. In brief, we see three avenues to extend the Tariff Preference Limit: 1) the amendment mechanism of CAFTA itself, 2) an amendment to the Caribbean Basin Trade Partnership Act, and 3) utilization of CAFTA's "short supply" provision.

Though I would not rule out any one option, a straight-forward attempt to extend the TPL via legislation may have the greatest chance of success.

#### BACKGROUND

##### CAFTA (August 2004):

On August 5, 2004, Nicaragua and the United States signed the Dominican Republic-Central America-United States Free Trade Agreement (CAFTA). Annex 3.28 of CAFTA, as originally negotiated, permitted Nicaragua to export to the United States, duty free, a certain quantity of apparel containing non-originating fabric, as long as the constituent fabric was cut and sewn within Nicaragua.<sup>1</sup> This tariff preference limit for Nicaraguan apparel containing non-originating fabric, called a "TPL" in trade parlance, was scheduled to last for nine years after entry into force.<sup>2</sup> For the first five years after entry into force, CAFTA, as originally negotiated, established a TPL of 100 million apparel square meter equivalent units (or SMEs).<sup>3</sup> The TPL was then set to phase out over the succeeding four years, with a TPL of 80 million SMEs in the sixth year after entry into force, a TPL of 60 million SMEs in the seventh year, a TPL of 40 million SMEs in the eighth year, and a TPL of 20 million SMEs in the ninth year.<sup>4</sup> Nicaragua's TPL was then scheduled to expire at the beginning of the tenth year after entry into force.<sup>5</sup> The TPL excluded wool apparel.

Article 3.25 of CAFTA outlines the process by which CAFTA countries can amend the Agreement's rules of origin for apparel, including Nicaragua's TPL. Article 3.25 permits any CAFTA country to request a modification to the apparel rules of origin, and requires the CAFTA countries to engage in an initial consultation within 30 days of such a modification request.<sup>6</sup>

<sup>1</sup> Dominican Republic-Central America-United States Free Trade Agreement, Annex 3.28, August 5, 2004.

<sup>2</sup> *Id.*

<sup>3</sup> *Id.*

<sup>4</sup> *Id.*

<sup>5</sup> *Id.*

<sup>6</sup> Dominican Republic-Central America-United States Free Trade Agreement, Article 3.25, August 5, 2004.

Article 3.25 does not contain a deadline by which Parties must conclude amendment negotiations, so consultations under Article 3.25 can drag on indefinitely.

Should negotiators reach agreement under Article 3.25 to modify the apparel rules of origin, negotiators must present the proposed modification to the CAFTA Free Trade Commission,<sup>7</sup> a Cabinet-level body empowered under Article 19.1 of CAFTA to approve all modifications to the Agreement. Article 19.1 requires the Free Trade Commission to unanimously approve all rule of origin changes. Article 19.1.6 encourages the Free Trade Commission to meet at least once per year to dispose of pending business.<sup>8</sup>

CAFTA Implementation Act; Initial Amendment Discussions (May - August 2005):

In the spring of 2005, the Bush Administration determined that the Administration would need the votes of textile State Members of Congress to garner House approval of the CAFTA implementing legislation. The Administration therefore undertook an effort to convince the Board of the National Council of Textile Organizations (NCTO) to endorse CAFTA, believing that a NCTO endorsement would provide textile State Members "cover" to vote in favor of the agreement.

One NCTO Board Member, an exporter of bottom-weight fabric to Nicaragua, initially balked at support for CAFTA, claiming that Nicaragua's TPL would erode an important export market for his company. The Bush Administration then sought, and obtained, an informal agreement from the Government of Nicaragua to negotiate changes to Nicaragua's TPL. Specifically, the Government of Nicaragua agreed to require woven trouser makers to use matching amounts of U.S. and foreign fabrics (a "one-for-one" sourcing arrangement). In exchange, the U.S. Government informally agreed to provide Nicaragua with a stable, 100 million SME TPL over the entire term of the TPL.

On July 18, 2005, Nicaragua sent a letter to the U.S. Trade Representative, memorializing the aforementioned agreement to amend Nicaragua's TPL, and promising to do so "expeditiously" after entry into force. The Bush Administration then obtained the support for CAFTA of several textile State Members of Congress.<sup>9</sup> On July 25, 2005, the House of Representatives passed the Dominican Republic-Central America-United States Free Trade Agreement Act (the "CAFTA Implementation Act").<sup>10</sup> The Senate followed suit later the same day and, on August 2, President Bush signed the implementing legislation into law.<sup>11</sup>

Section 203(o)(3)(A) of the CAFTA Implementation Act makes it more difficult to amend CAFTA's rules of origin for apparel than for all other products. Indeed, Section 203(o)(3)(A) forbids the executive branch from implementing any change to CAFTA's apparel rules of origin.

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<sup>7</sup> *Id.* at Article 3.25.3.

<sup>8</sup> *Id.* at Article 19.1.6.

<sup>9</sup> The Administration also obtained letters from each CAFTA Party promising to amend CAFTA's pocketing rules of origin, and wrote a letter to a Member of Congress from Alabama promising that the Administration would invoke CAFTA's apparel safeguard, "if the facts warrant", to inhibit sock imports. These assurances, too, played a role in garnering textile State Member support for CAFTA.

<sup>10</sup> Dominican Republic-Central America-United States Free Trade Agreement Act, H.R. 3045, 109th Cong. (2005).

<sup>11</sup> 19 U.S.C. § 4001 *et seq.*

Section 203(o)(3)(A), in effect, requires the executive branch to obtain explicit legislative approval for any apparel rule of origin change. Meanwhile, for all other products, Section 104 of the CAFTA Implementation Act permits the Executive Branch to implement changes to CAFTA's rules of origin after consulting with the International Trade Commission, an industry trade advisory committee, the House Ways & Means Committee, and the Senate Finance Committee.

Section 402 of the CAFTA Implementation Act terminated Nicaragua's benefits under the Caribbean Basin Trade Partnership Act (CBTPA), effective the day Nicaragua became a CAFTA beneficiary.

*Amendments to CAFTA; U.S. Legislative Approval Thereof (March 2006 - August 2007):*

By exchange of letters on March 24 and March 27, 2006, Nicaragua and the United States agreed to promptly engage in formal consultations to amend Nicaragua's TPL, reflecting the bargain reached in 2005, upon CAFTA's entry into force for Nicaragua on April 1, 2006. Specifically, Nicaragua and the United States agreed to permit wool sport coats to benefit from Nicaragua's TPL, with a sublimit of 1.5 million SMEs annually. The United States and Nicaragua also agreed to increase Nicaragua's TPL in the sixth through the ninth years of the Agreement to 100 million SMEs.

Finally, the U.S. and Nicaragua agreed to administer Nicaragua's TPL in such a way as to require Nicaragua's woven trouser manufacturers to purchase one square meter of U.S. fabric for every one square meter of TLP-qualifying woven trouser fabric. Under this "one for one" purchasing arrangement, for each square meter equivalent of woven trouser exports entered under the TPL, Nicaragua agreed to export to the U.S. an equal amount of woven trousers made of U.S. fabric of U.S. yarn.

The Parties agreed to permit this "one for one" purchasing rule to phase in over time for cotton trousers. In the first year after entry into force, the "one for one" purchasing rule was to apply to the first 20 million SME of cotton woven trousers imported into the United States under the TPL. In the second year, the "one for one" purchasing rule was to apply to the first 30 million SME of cotton woven trousers imported into the United States under the TPL. In the third year, the "one for one" purchasing rule was to apply to the first 40 million SMEs of cotton woven trousers imported into the United States under the TPL. In the fourth and subsequent years, the "one for one" purchasing rule was to apply to the first 50 million SMEs of cotton woven trousers imported into the United States under the TPL. Any exports of cotton trousers made in excess of 50 million SMEs would not be subject to the "one for one" purchasing rule.

Nicaragua also agreed to supply data to the U.S. Government, detailing exports from Nicaragua of woven trousers containing U.S. formed fabric of U.S. formed yarn. If the U.S. determines that the amount of woven trouser exports made under the TPL exceeds the amount of woven trouser exports made from U.S. formed fabric of U.S. formed yarn, the U.S. will reduce Nicaragua's TPL if the excess is not rectified by April 1 of the following year.



Because the CAFTA Implementation Act forbids the executive branch from implementing apparel rule of origin changes, the Bush Administration had to obtain specific congressional authorization to implement its agreement with Nicaragua to amend Nicaragua's TPL. Congress obliged, tucking a provision into the Pension Protection Act of 2006, signed into law on August 17, 2006, granting the President the authority to proclaim changes to the Harmonized Tariff System (HTS) altering the terms of Nicaragua's TPL. The President's authority to do so, though, was set to expire on December 31, 2007.

On July 27, August 6, and August 14, 2007, Nicaragua, the United States, and the other CAFTA Parties signed formal agreements to make several changes to CAFTA's apparel rules, including the changes to Nicaragua's TPL outlined above.

*U.S. Implementation of Nicaragua's Amended TPL (December 2007 - August 2008):*

On December 20, 2007, President Bush signed Proclamation 8213 (as amended by Proclamation 8272 of July 3, 2008), modifying the HTS to implement the agreement with Nicaragua to alter Nicaragua's TPL. Proclamation 8213 and Proclamation 8287, though, declared that the modifications would enter into force for goods entered or withdrawn from warehouse upon a date to be announced by USTR. USTR subsequently declared that the changes to Nicaragua's TPL would go into effect on August 15, 2008.

**Avenues to Extend Nicaragua's TPL**

Nicaragua's CAFTA TPL is clearly an important element in a government-led strategy to attract and retain apparel investment in the Western Hemisphere. Though Nicaragua utilized only 75% of the TPL in the first year of CAFTA (2006-2007),<sup>12</sup> Nicaragua has utilized in excess of 94% of the TPL in every year since.<sup>13</sup> Though an extension of Nicaragua's TPL is imperative for those who source in the region, stakeholders have limited procedural mechanisms with which to seek an extension of the TPL. Each procedural option entails likely lengthy negotiations and implementation, necessitating that stakeholders act soon in order to ensure that the TPL remains in place four years hence.

Regional investors have three options by which to extend Nicaragua's CAFTA TPL: 1) two amendment mechanisms within CAFTA, and 2) an extension via amendment of the Caribbean Basin Trade Partnership Act preference program (or the creation of a stand-alone preference program solely for Nicaragua). There are simply no other credible means by which the textile industry and investors could achieve an extension of the TPL.

*1. CAFTA's Apparel Chapter Amendment Provision:*

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<sup>12</sup> Because CAFTA went into effect for Nicaragua on April 1, 2006, U.S. Customs and Border Protection administers, or measures, Nicaragua's TPL from April 1 of one year to March 31 of the succeeding year. Nicaragua's first "TPL year", therefore, was from 4/1/06 to 3/31/07.

<sup>13</sup> Nicaragua's TPL was 94.3% full at the end of the 2007-2008 "TPL year", 97% full at the end of the 2008-2009 "TPL year", and 100% full at the end of the 2009-2010 "TPL year." See embedded Excel file conveying the historic fill rate of Nicaragua's TPL on Customs & Border Protection's website at: [http://www.cbp.gov/xp/cgov/trade/trade\\_programs/textiles\\_and\\_quotas/quotatariff\\_fill\\_rates/](http://www.cbp.gov/xp/cgov/trade/trade_programs/textiles_and_quotas/quotatariff_fill_rates/)

As outlined above, the CAFTA contains a provision by which the Parties can amend the Agreement's rules of origin. Article 3.25 of CAFTA outlines the process by which CAFTA countries can amend the agreement's rules of origin for apparel. Of course, Nicaragua and the United States have already utilized Article 3.25 once, to alter Nicaragua's TPL just after entry into force. Article 3.25 permits any CAFTA country to request a modification to the apparel rules of origin and requires the CAFTA countries to engage in an initial consultation within 30 days of such a modification request. The CAFTA countries must unanimously approve any change to the rules of origin under the auspices of the CAFTA Free Trade Commission, a Cabinet-level Commission empowered by Article 19 of CAFTA to modify the rules of origin.

It would be difficult, though not impossible, for Nicaragua to obtain an extension of the TPL via Article 3.25:

- a.) First, the United States may initially be reluctant to approach the other CAFTA countries to seek agreement on an extension of Nicaragua's TPL. Fellow CAFTA nations are unlikely, of course, to agree to an extension of Nicaragua's TPL without extracting significant, new concessions from the United States.
- b.) Second, even if the United States and Nicaragua were able to utilize Article 3.25 to negotiate an extension of Nicaragua's TPL, the Administration would have to garner legislative approval of the package from the U.S. Congress. Congressional approval may not be contentious (after all, one would hope that Congress would approve a CAFTA amendment unanimously agreed upon by all CAFTA Parties), but trade bills are always difficult to move on Capitol Hill and the identification of, and utilization of, an appropriate legislative vehicle can result in a lengthy delay. It's worth noting, though, that the United States was able to amend CAFTA recently by tacking a CAFTA amendment onto another legislative vehicle: The United States amended the CAFTA Implementation Act to create a CAFTA "earned import allowance" program for the Dominican Republic by tacking the Dominican Republic's "earned import allowance" program onto the Andean Trade Preference Extension Act of 2008.<sup>14</sup>

Despite these hurdles, a key political factor may permit an extension of the TPL via Article 3.25 (or, for that matter, via legislation): In the years since implementation of CAFTA, the U.S. textile industry may have decided that Nicaragua's "one for one" purchasing arrangement for woven trousers has boosted U.S. exports of bottom weight fabric. U.S. fabric exports to Nicaragua have, after all, grown significantly in recent years, from \$57.3 million in 2006 to \$104 million in 2010 -- an incredible 82% increase in the face of a recession and growing imports from Asia.<sup>15</sup>

If the United States were to approach other CAFTA Parties, via Article 3.25, seeking an extension of Nicaragua's TPL, the United States may then have to offer other CAFTA Parties apparel concessions to entice them to support this change. Indeed, other CAFTA parties may seek TPLs with permutations unique to each CAFTA party (*e.g.*, various product-specific

<sup>14</sup> Andean Trade Preference Extension Act of 2008, Public L. No. 110-191, §2, 122 Stat. 646 (2008).

<sup>15</sup> See U.S. Department of Commerce, International Trade Administration, Import Administration, Office of Textiles and Apparel's, "Export Market Report: U.S. Exports of Textiles and Apparel 1989 - 2010" data for Nicaragua, which can be found at the following link: <http://www.otexa.ita.doc.gov/scripts/exphist.exe>

sublimits), or may seek cut and sew rules for additional apparel products. In addition, CAFTA Parties may use Article 3.25 consultations to demand changes to CAFTA outside of the apparel chapter. These options will almost inevitably arise in multilateral consultations held pursuant to Article 3.25, complicating any effort by the United States to extend Nicaragua's TPL.

## *2. An Amendment to CBTPA:*

Nicaragua, of course, can no longer utilize trade preferences under the Caribbean Trade Partnership Act (CBTPA). Section 402 of the CAFTA Implementation Act removed Nicaragua from CBTPA. Interestingly, though, no provision of the CAFTA itself prohibits a beneficiary country from enjoying CBTPA benefits. The United States could amend CBTPA to add Nicaragua back into the unilateral preference program and to extend Nicaragua's TPL without violating CAFTA.

Congress, of course, has the fundamental authority to regulate trade, and CAFTA did not take this authority away. Under its simple constitutional authority to regulate trade, Congress can enact new trade benefits for countries in the region, or amend or extend pre-existing benefits, including, of course, Nicaragua's TPL.

One may ask whether Congress' exercise of this authority could lead to dispute resolution under CAFTA, but the response to such an inquiry is both that dispute resolution is unlikely in the context of a simple extension of a popular benefit for Nicaragua (a benefit which, after all, operates bilaterally, governing U.S. - Nicaragua trade and does not, at least directly, impact other CAFTA members), and that the United States has once before provided a benefit to a CAFTA country legislatively with the Dominican Republic's "earned import allowance program". (see below)

An extension of Nicaragua's TPL via an amendment to CBTPA may be more feasible than an effort to utilize the amendment provision of CAFTA to extend the TPL. Indeed, a simple legislative extension of Nicaragua's pre-existing benefits, undertaken with the support of the textile industry and retail and apparel brands, may be more likely to bear fruit than an attempt to formally amend CAFTA via Article 3.25.<sup>16</sup>

## *3. A New Preference Program for Nicaragua:*

The U.S. Congress could also unilaterally extend Nicaragua's TPL by creating a new, stand-alone preference program for Nicaragua. Congress could tack such a stand-alone preference program onto an appropriate legislative vehicle, or pass the program as a distinct piece of legislation. Adoption of a stand-alone preference program would be legally distinct from option number 2 above (an amendment to CBTPA), simply because the authorizing legislation would not amend CBTPA, thus subsuming Nicaragua's TPL into the CBTPA program.

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<sup>16</sup> Again, per the above section on CAFTA's amendment mechanism, an attempt to extend Nicaragua's TPL via CAFTA Article 3.25 would likely be burdened by demands for new concessions by other CAFTA Parties and be delayed by a process devoid of deadlines.



There is precedent for the creation of a new, stand-alone preference program for a CAFTA member-country: Congress created an "earned import allowance" program for the Dominican Republic, not by amending CBTPA, but by passing legislation to create a separate, stand-alone benefit for the Dominican Republic.<sup>17</sup>

#### *4. The CAFTA Short Supply Process:*

CAFTA Article 3.25 contains a "short supply" provision, that permits any "interested entity" (including a CAFTA government) to petition the United States to declare that a specified fabric is not produced by CAFTA textile mills "in commercial quantities in a timely manner." If the United States agrees that the specified fabric is not available in commercial quantities in a timely manner, the United States shall add the specified fabric to a list of short supply fabrics in Annex 3.25 of the agreement. Inclusion of a fabric on the Annex 3.25 short supply list permits CAFTA apparel producers to export apparel containing the specified fabric duty free to the United States, regardless of the origin of the fabric.

In theory, Nicaragua or an apparel producer could petition the U.S. Government to declare that certain fabrics of importance to Nicaraguan apparel producers are in "short supply." If the U.S. Government were to approve such a petition, the U.S. Government would permit duty-free entry of apparel made of those fabrics, regardless of the origin of the fabric, so long as the apparel was cut and sewn in Nicaragua, effectively extending Nicaragua's TPL.

This option, though, would have little to no chance of success. First, a short supply petition would provide no relief to Nicaraguan trouser producers who have a track record of purchases of U.S. fabric. Second, short supply petitions, as a rule, affect fabric for which there is low trade volume.

#### **CONCLUSION**

Nicaragua's TPL, of course, has been a vital tool in a region-wide effort to maintain and attract apparel production in the Western Hemisphere. Additionally, the Nicaragua "one for one" arrangement has led to a measurable expansion of U.S. textile exports. It is therefore imperative for interested parties to seek an extension. The most straight-forward, and likely successful, means to achieve an extension would be a simple legislative extension of Nicaragua's existing benefits, an effort that must begin soon, bearing in mind that textile and apparel companies plan sourcing strategies years in advance.

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<sup>17</sup> Andean Trade Preference Extension Act of 2008, Public L. No. 110-191, §2, 122 Stat. 646 (2008). The Andean Trade Preference Extension Act placed this new, stand-alone preference program for the Dominican Republic within the Dominican Republic-Central America-United States Free Trade Agreement Act, H.R. 3045, 109th Cong. (2005).

## **Extend TPLs for Nicaragua**

### **Background on Nicaragua's Tariff Preference Levels**

In 2005, the U.S. Congress approved the Dominican Republic-Central American-United States Free Trade Agreement (CAFTA), which established tariff preference levels (TPLs) for cotton and man-made fiber apparel from Nicaragua. TPLs are commonly used in U.S. free trade agreements, and were first established under NAFTA as a way of granting limited duty-free access for garments that did not qualify for the strict yarn-forward rule of origin.

Nicaragua was the only CAFTA country that sought TPLs during the negotiations. As the least developed CAFTA country and the smallest supplier of textile and apparel products, Nicaragua needed TPLs to spur growth and create jobs.

Following the conclusion of negotiations, and before CAFTA was submitted to Congress for approval, some U.S. textile companies expressed concern the TPL would hurt their U.S. production of bottom weight fabrics. To address this concern, Nicaragua accepted a "1-for-1" requirement for the production of trousers to encourage Nicaraguan companies to use U.S. fabrics, with a penalty that reduces the TPL if Nicaragua does not meet the 1-for-1 goal.

### **Role of the TPL**

The TPLs helped transform Nicaragua's textile and apparel sector. Before CAFTA was implemented, Nicaraguan companies primarily consisted of cut-and-sew operations. With the TPL incentives, Nicaragua was able to attract new investments from companies that produce fabric and garments using U.S. inputs, as envisioned by the 1-for-1 agreement. These investments boosted both Nicaraguan production and U.S. fabric exports.

The numbers illustrate this success. Nicaragua is now the third largest market for U.S. exports of broadwoven fabrics, behind only Mexico and Canada. In turn, Nicaragua is now the 12th largest supplier of apparel products to the United States. This growth strengthens the hemispheric sector, benefiting companies in the United States and across the region and serving as an important bulwark against rising competition from Asia.

In short, the TPLs are good for the United States and Nicaragua.

### **Action is Needed to Extend the TPLs**

The TPLs are scheduled to expire on December 31, 2014. U.S. brands and retailers map out their sourcing strategies several years in advance. A number of large companies have already said they will revise sourcing plans to manufacture in Nicaragua if there is uncertainty about the TPLs. In turn, this would hurt Nicaraguan purchases of U.S. fabrics currently expected from Nicaragua factories.

To facilitate continued growth in both countries, and to further strengthen the regional textile and apparel platform, Congress should extend the TPLs.



**A Legislative Extension of the Nicaragua TPL: Summary Legal Analysis**

In 2004, Nicaragua and the United States signed the Central America-United States Free Trade Agreement (CAFTA). Annex 3.28 of CAFTA, as amended, permits Nicaragua to export to the U.S., duty free, 100 million square meter equivalents (or SMEs) of apparel containing non-originating fabric, as long as the constituent fabric is cut and sewn within Nicaragua. This tariff preference limit for Nicaraguan apparel containing non-originating fabric, called a "TPL" in trade parlance, lasts until the end of 2014.

The U.S. and Nicaragua agreed to administer Nicaragua's TPL in such a way as to require Nicaragua's woven trouser manufacturers to purchase one square meter of U.S. fabric for every one square meter of TPL-qualifying woven trouser fabric. Under this "one for one" purchasing arrangement, for each square meter equivalent of woven trouser exports entered under the TPL, Nicaragua agreed to export to the U.S. an equal amount of woven trousers made of U.S. fabric of U.S. yarn, up to a 50 million SME annual cap.

The U.S. Government can extend the Nicaragua TPL using two, basic mechanisms: 1) the amendment mechanisms within CAFTA, and 2) an extension via amendment of the Caribbean Basin Trade Partnership Act (CBTPA) preference program (or the creation of a stand-alone preference program solely for Nicaragua).

Congress, of course, has the fundamental authority to regulate trade. CAFTA didn't take this authority away. Under its constitutional authority to regulate trade, Congress can enact new trade benefits for countries in the region, or amend existing benefits.

One may ask whether extension of Nicaragua's TPLs through CBTPA would be vulnerable to legal challenge under CAFTA. In short, the answer is no. Such a challenge would be neither likely to arise nor to succeed. The TPLs were established by CAFTA and a simple extension would impose no changes on the status quo, much less directly impact other CAFTA members. Notably, Congress has already unilaterally provided a benefit to a CAFTA country, when it enacted an "earned import allowance" program for the Dominican Republic, choosing a legislative solution rather than utilizing CAFTA's amendment mechanism.